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Banking Nationalism on the Road to Banking Union

Rachel A. Epstein and Martin Rhodes

Abstract

European states have a long history of banking sector nationalism. Control over credit allocation is believed to contribute to economic development and competitiveness goals, insulation from external economic shocks, and control over monetary policy. This paper explains the potentially dramatic loss in domestic control over banks created by the European Banking Union (EBU). First, we argue that ongoing liberalization in the global and European economies has made banking sector protectionism both more costly and conflictual. Second, we contend that because many of the biggest banks have internationalized their operations, they now prefer centralized European regulation and supervision. Third, supporting a modified neofunctionalist argument, we find that behind the sometimes frenetic intergovernmental bargaining in 2012-14, it is primarily the European Commission and the European Central Bank that have pushed Banking Union ahead. Supranational institutions have argued, with some success, that they have unique capacity to solve collective action and prisoners' dilemma problems. Contrary to accepted wisdom, Germany has not set or limited the Banking Union agenda to a great extent, in part because of its own internal divisions. Moreover, the Commission and the ECB have managed at critical junctures to isolate Germany to secure the country's assent to controversial measures.

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1. Introduction[1]

This paper fundamentally challenges the famous aphorism in its title, that traditionally banks were "international in life and national in death"[2]. In fact, we argue that the national political foundations of banks have been enduring and powerful. Thus banks have always been national in life, even as they have become increasingly globally active. It is only through the realization of some form of (supranational) banking union, starting with centralized supervision at the expense of national authority, that West European banks could become truly international in life. As the European debt and currency crisis has demonstrated, however, an important step towards sustaining the Euro may be to ensure that banks become international in death. While on some level states might appreciate being let off the hook for national bank bail-outs that ruin their public finances, an enormous loss of control is implicit in such a change.

Traditionally, states have exercised considerable authority over banks. Domestic control over finance has been linked to developmental strategies, insulation from external economic shocks, and the execution of monetary policy. Moreover, through the regulation and supervision of banks, states have sought to balance the sector's risks and returns—not only to maximize profits and efficiency, but equally as important, to provide stability for the national economy. For all of these and other reasons (see Pauly 1988), most states have retained domestic bank ownership up until the last two decades, in which a number of smaller, weaker countries has allowed an increase, or even a majority, in foreign ownership of their banks (Epstein 2008a; Martinez-Diaz 2009; Stein 2010; Etchemendy/Puente 2011). However, among powerful and rich countries banking sector protectionism has remained very much alive. Nowhere has that tendency been more manifest than in Western Europe, home to some of the world's largest economies, biggest banks, and, for the last four years, the world's worst economic crisis.

The central question under scrutiny here is then why, given West European states' concerns about stability, autonomy and prosperity and the perceived link between these goals and national control over banks, West European states have nevertheless agreed to take major steps toward a European Banking Union (EBU) in the form of centralization of supervisory authority in the European Central Bank (ECB) via the Single Supervisory Mechanism (SSM). From the end of 2013 and into 2014, the ECB had been preparing its Asset Quality Review (AQR) of Europe's 130 largest banks (and banking groups), which together comprised 85 percent of the region's banking assets. While the other two pillars of the EBU, the funding for a European bank resolution and a pan-European deposit insurance, were still being negotiated and refined in the first half of 2014, we seek to emphasize in this chapter the major change that such centralized supervision represents. No longer would individual states have the capacity to balance banks' risks and returns in service of the national economy; to assist in competitive banking on behalf of their sectors; to prevent the winding-down of favored national financial institutions; or most dramatically, to prevent foreign entrants from absorbing much larger shares of a country's banking assets.

1 We would like to thank Thomas Risse, Nicolas Véron, Jim Caporaso, Randall Henning, Jonathan Moses, Peter Hall, Randall Germain, Samuel McPhilemy, Manuela Moschella, Marius Skuodis for their comments and advice. All errors are ours.

2 This quotation is attributed to both Bank of England Governor Mervyn King and economist Charles Goodhart.

To explain the major shift induced by the onset of the European Banking Union, we advance three arguments. First, as we detail in section one of this paper, at the most general level, both the global economy and Europe's regional economy have changed in ways that make protectionism in any particular sector more difficult. Much like liberal political economists had predicted, pockets of political authority (in this case over banks) in the context of easing exogenous costs of international economic exchange generated new, and in some cases increasingly intense conflicts and contradictions (Frieden 1991; Frieden/Rogowski 1996; see also Epstein 2014a). Since the introduction of the Euro in 1999, more states have had to devote more resources to retain domestic bank control because the common currency empowers bond markets at the expense of states and banks, and provides a new channel of contagion in the euro area. We are not arguing that crisis necessarily leads to changes that successfully accommodate the sources of any given crisis. But we do contend that these new, and newly intense conflicts and contradictions have provided the space within which Europeans have reconsidered the trade-offs they face.

Second, as we argue in section two, European banks are less beholden to their home states and markets than hitherto assumed due to significant market consolidation in banking across the European continent, and they are also less responsive to political influence of their home states (Macartney 2013; Epstein 2014b). Ironically, it was a specific form of banking nationalism in Europe that caused this structural shift in which banks moved away from states. With the completion of the single market in the 1980s, most EU member states orchestrated domestic consolidation in banking to ensure their banking sectors' longevity—both to gird against foreign competition that would intensify with market liberalization, and to prevent foreign takeover. Even more important for the structural shift between states and banks, was the fact that EU member states supported their own banks' outward expansion. While much of this outward expansion was directed toward post-communist Europe (Epstein 2008a and 2008b), some took place within Western Europe, but also beyond the EU. The internationalization of formerly domestically-oriented banks has changed those banks' interests. Specifically, they are likely to favor centralized regulation and supervision in order to escape national legal peculiarities and to enjoy more flexibility with respect to capital and liquidity management within their own multinational structures.

Third, we argue in part three of this paper, in line with neofunctionalist arguments, that Europe's supranational institutions have taken advantage of the crisis to push through reforms that fundamentally contradict the perceived interests of many member states. Those institutions have been empowered in a number of ways. First, supranational actors have been able to frame the ways in which international, European and national pressures are perceived and accommodated by member states. The European Commission (or "the Commission") and the ECB, supported by the majority of MEPs in the European Parliament, and backed by Europe's most powerful banking lobbying groups, have redefined those interests with regard to state control and sovereignty in banking, creating a new understanding of how stability and prosperity can be achieved. That strategy has, of course, been facilitated by the contradictions and conflicts generated by the structural shifts mentioned above. In addition, over the course of the crisis some member states have gone through a rapid learning process in which they have begun to understand that, in order to escape the collective action and prisoners' dilemma problems afflicting a purely intergovernmental response to Europe's banking crisis, their interests would be best served by a supranational solution.

In terms of policy dynamics, the European Commission, in close cooperation with the ECB, has, at critical points, used its strengthened position to construct a coalition of EU member states backing a banking union. It has employed well-proven tactics (for example policy venue shopping) to weaken the position of Germany, in order to secure German agreement to centralized banking supervision - even when German politicians and bankers threw up barriers in an attempt to stall ultimate resolution. Thus in section three, we analyze closely three episodes of political conflict and compromise involving the supranational institutions and member states: first, the centralization of banking supervision in the new Single Supervisory Mechanism; second, controversy surrounding the use of the ESM (European Stability Mechanism) to bail out banks and plans for bank recapitalization under the Banking Union; and third, the most contentious issue – the level of authority and sources of financing for bank recovery and resolution. These three episodes in the constitution of the Banking Union (our dependent variable) show some variation, as we would expect, given their different implications for national control over banks and the mutualization of bank debt. While the transfer of sovereignty in banking supervision is almost complete by now, there is still much sparring between the Commission, the ECB and the rest of the pro-banking union coalition with Germany and its allies over banking recapitalization and resolution. In those areas, where the Banking union touches upon political and fiscal union, awkward compromises between EU centralization and national decentralization have arisen. Yet, we argue that the rapidity with which such loss of sovereignty has occurred is nevertheless impressive, and that the policy path taken will eventually lead to more integration at the European level.

2. Liberalization and the Rising Costs of Banking Nationalism

West European states have a long history of banking sector protectionism (Barth/Caprio/Levine 2006: 149-50). Liberalization in the global economy and within the EU has led to the intensification of conflicts associated with national control over banks, as well as rising costs, such as uncompetitive fees and lending rates. According to liberal political economists, we should expect pockets of political authority to be increasingly difficult to maintain within a larger context of liberalization (Frieden 1991; Frieden/Rogowski 1996). Frieden and Rogowski argue that especially since the 1980s, we have seen a dramatic decrease of the 'exogenous costs' of international economic exchange, largely due to free trade agreements, increasing capital mobility and new technologies that make communication and transport both faster and cheaper. Reduced costs of international economic exchange have two effects on protected economies. First, they increase the opportunity costs of not liberalizing markets. As others liberalize, liberalizers themselves benefit from the efficiencies that specialization and exchange generate, while those that opt out do not. Second, reduced costs of international economic exchange raise the relative costs of the products and services that protectionist states produce, making those states less competitive.

As relative prices in the global economy shift because of uneven liberalization, the potential, though not the certainty, for new conflicts increases. The most competitive industries may fight for more market opening if they can get higher prices for their products on world markets than at home. For less competitive sectors the opposite impulse is more likely - these will probably seek to maintain protection and higher domestic prices relative to international ones, that such protection yields. Though Frieden and Rogowski do not rule out that actual policies may not create the greatest efficiency, they do argue that we are more likely to observe increased market opening in response to shifting relative prices in democratic societies, where publics - including consumers and taxpayers - wield influence (Frieden/Rogowski 1996: 36, 43).[3]

We argue that it is exactly this shifting of relative prices in the context of increased economic exchange that has boosted the costs of banking sector protectionism and generated new conflicts. Rising costs and intensifying conflict have, in turn, driven policy innovation in the European Banking Union, and more specifically, have lent support for centralized European banking supervision. While centralized supervision represents a changed locus of authority, from national to supranational, it also signals the intensifying use of markets to govern banks. Market logic will be applied more aggressively by a single supervisor at the ECB than by national authorities because the ECB, as opposed to member states, lacks the motivation to maintain particular political affiliations with banks. Two major developments in international economic integration bear on the costs of states maintaining political affiliations with their banks: first, the rise of international capital mobility (Frieden 1991; Goodman/Pauly 1993; Grabel 2003; Frieden 2006; Abdelal 2007), and second, specific to Europe, the introduction of a common currency, the Euro, in 1999.

International capital mobility together with the common currency conspired to turn a classic, though particularly severe, economic shock in 2008 (Kindleberger 2000 [1978]) into an existential crisis for the Eurozone and the European Union. Although the crisis has most often been termed as a sovereign debt crisis, our interpretation is, that the protracted and encompassing nature of the crisis is more directly linked to West European states' attachment to their banks (see also Epstein 2014a). Specifically, international capital mobility has empowered bond traders, whose aggregate movements can change the economic fortunes of states and banks from one day to the next, depending on how much they charge to lend. As yields increase, not only do states face higher borrowing costs, but banks' balance sheets suffer - assuming the banks in question have lent disproportionately to their sovereign. In Europe, given national regulatory authority, this has always been the case (Bini Smaghi 2013; Gros 2013). Thus we arrive at the first major cost associated with banking sector protectionism in the context of increasing international economic exchange: the financial vulnerability of both banks and states by virtue of their political affiliations, as constructed by national regulations and incentives that encouraged domestically-controlled banks to finance their sovereigns (see also Speyer 2012).

The common currency's introduction in 1999 was another form of economic liberalization (like increasing international capital mobility) that created new costs of banking sector protectionism. Because the Euro replaced national currencies, it removed national political control over relative external currency values - that is whether to allow market-driven devaluation or defend against devaluation. The elevation of markets and a narrowing of political authority caused by the introduction of the Euro are, in some sense, more dramatic than under the gold standard because, under the latter regime, states had a specified exit option, unlike within the Eurozone (Polanyi 1944; Ruggie 1982; Eichengreen 1992; Simmons 1994; Matthijs 2014). Although multinational banks stand to gain from a common currency because they no longer have to worry about devaluation affecting their assets and liabilities across borders, a more important consideration in nationally-fragmented banking sectors is competitiveness. And indeed, in the absence of adjustment other than internal devaluation, repeated or long-term recessions take their toll on banks' balance sheets,

3 For an analysis of why broad public pressure is unlikely to matter, see Olsen 1982.

increasing non-performing loan volumes and limiting new business activities (Italy is a case-in-point, see Sanderson/Jenkins 2013). Thus, the contradiction in this case lies between a common currency, on the one hand, and nationally-fragmented banking sectors on the other. Banking systems based in recession countries end up compounding the problem of limited adjustment tools, rather than countering it. The second cost stemming from uneven liberalization is therefore limited adjustment.

The contradiction between having a common currency, and thus a single monetary authority, and banking market fragmentation has led to another cost for the euro area - namely the ineffective transmission of monetary policy by the ECB. European banks with cross-border reach have withdrawn their lending from foreign, back into domestic markets. National retreat, a symptom of continuing political authority that guides bank behavior, ran counter to the need for *less* risk concentration in the EU's financial markets, and forced the ECB to bolster the interbank market with its own liquidity provision (Speyer 2012: 3). Member states meanwhile have resisted a hardening of European soft law initiatives in the form of Memoranda of Understanding (MOUs) to help develop a common, cross-border system for the resolution of failed banks (Kudrna 2012). By early 2014, the ECB was still grappling with how to cope with this third cost, ineffective monetary policy transmission, and particularly the problem of "credit-starved small businesses" (Jones/Barker/Thompson 2014: 6).

Fourth, in addition to limiting adjustment to internal devaluation, the Euro has raised the costs of banking sector protectionism by creating a channel of contagion through which states' vulnerabilities travel. Obviously, there are multiple channels of contagion in the global economic system, and countries do not need to share a currency to experience linked capital account, banking or fiscal crises. At the same time, one could imagine a world before the Euro, in which a crisis in Greece would not unduly raise Italian borrowing costs despite high Italian public debt-to-GDP levels, given Italy's comparatively diverse production profile and strong capital accumulation measures. With the Euro, however, creditors and investors do just not worry about Greek default and exit, but whether other EU member states would also be allowed to leave the Eurozone, given insufficient bail-out facilities. Another contradiction is, therefore, the collectivization of risk through the common currency, without commensurate pooling of responsibility - a contradiction that by 2012 was widely appreciated, but whose effects were anticipated by few (Eichengreen 1993 was an exception). Banks and states that were not regarded as vulnerable before the introduction of the Euro, have therefore become subject to intensive new market scrutiny, following its implementation - the fourth major cost of uneven liberalization. Meanwhile, the Euro itself was imperiled.

Through much of the crisis, at least until 2012, EU member states, as well as the EU's supranational institutions, seemed content to absorb the costs of banking sector protectionism, despite the fact that such policies prolonged and exacerbated the crisis. In particular, states have taken on the enormous fiscal burden of bailing out their own banks, in large measure to keep domestic banks domestic - with the support of the European Commission (Donnelly 2011; Donnelly 2014; Epstein 2013). In theory, at least some of the ailing banks could have been wound down or sold to foreign interests at a much lower cost to taxpayers, states' fiscal positions and the common currency's credibility. In addition, the ECB's long term refinancing operations (LTROs), whose use was expanded on an increasingly liberal basis starting in 2011, reinforced the 'doom loop' in which zombie banks were lending even more money to their fiscally sick sovereigns, much as politicians, including French President Nicolas Sarkozy, hoped they would (Hume 2011; Milne 2011). The trade-off here was that as the ECB's actions lowered peripheral states' borrowing costs by taking pressure off the currency in the short-term, the longer-term effect was to amplify banks' and states' inter-dependent vulnerabilities.

We argue that there is nothing deterministic about the relationship between crisis and functional policy innovation. States and other actors can and do tolerate and absorb the high costs of uneven liberalization for long periods. In North's terms, inefficient institutions often endure when key actors' power positions are at stake (North 1981; see also Streeck/Thelen 2005; and with regard to banking in particular Busch 2009). Our aim, consequently, is to pinpoint changes in the constellation of power and interest that opened the door for the European Banking Union.

2.1 Banking Nationalism on the Road to the Banking Union

We have implied that low levels of foreign bank ownership in the Eurozone's largest economies and West European banking sector fragmentation along national lines are the consequences of purposeful banking sector protectionism. In this section, we wish to prove that such protectionism does, in fact, exist. But we also argue that, paradoxically, states that encouraged banking behemoths with national identities, were, at the same time, sowing the seeds of their own political disenfranchisement. As banks grew through domestic consolidation and then, more importantly, through international expansion, they became less beholden to home political authorities, less responsive to home political entreaties and more interested in standardized regulations and centralized supervision for the purpose of managing their own resources and maximizing profitability.

While Eastern Europe opened its banking markets to foreign investors in the 1990s and early 2000s in the context of post-communist transition and EU accession, Western Europe's largest economies protected high levels of domestic control (see figures 1 and 2). In one example of West European protectionism, Mario Draghi, in 2006 when he was a relatively new governor of Italy's Central Bank, the Banca d'Italia, threatened Italian bankers in strident terms that he would not defend them against foreign investment or takeovers, as his predecessor did. Antonio Fazio attempted to prevent the Dutch ABN AMRO from taking over Banca Antonveneta in 2005 (Bickerton et al.: 2007). Yet, in March 2011, ten months before assuming the ECB presidency, Draghi used the regulatory powers of the Italian Central Bank to thwart the sale of UniCredit's asset management arm, Pioneer Investments, to competing French and British bidders. Instead, he suggested to the Italian banking group finance a marriage between Pioneer and San Paolo's Eurizon Capital Fund (Foster 2011). Apart from its protectionist agenda (inherited, it seemed, from the disgraced Mr. Fazio, who was forced to resign over the ABN AMRO/Antonveneta affair), the Banca d'Italia under Draghi also wanted to safeguard the purchase of Italian government bonds by local investors. The EU's 2006 Banking Directive, which specifically sponsored the promotion of cross-border banking services, paradoxically contained a clause that preserved this kind of protectionism.[4]

4 Ambiguous language in the 2006 Banking Direction (Art. 19) allows national authorities to block mergers and acquisitions of banks to "ensure sound and prudent management of the credit institution" (Grossman/Leblond 2008: 5).

Table 1: Foreign Bank Control - New EU Members

Country	*Percentage*
Bulgaria	84
Czech Republic	85
Croatia	91
Estonia	98
Hungary	81
Latvia	69
Lithuania	91
Poland	72
Romania	84
Slovakia	92
Slovenia	29

Table 2: Foreign Bank Control - Older EU Members and US

Country	*Percentage*
Austria	20
Belgium	50
Cyprus	19
Denmark	20
Finland	65
France	6
Germany	12
Greece	14
Ireland	56
Italy	6
Luxembourg	95
Netherlands	2
Portugal	15
Spain	2
Sweden	0
United Kingdom	15
United States	18

On a more systematic level, in 1999, the *Economist* wrote that in "some countries inside the European Union, financial regulators strive diligently to prevent foreigners from buying local banks" (1999: 58). Though by 2013 foreign bank ownership had increased in Western Europe (Goldstein/Véron, 2011: 6), that the EU Economic and Monetary Union "encouraged national authorities to protect their systems by limiting the licenses given to foreign banks" (Bini Smaghi 2013:82). But it was not just via regulation that West Europeans protected their banks. In the Eurozone's 3rd and 4th largest economies, Italy and Spain, studies have documented how bank privatization proceeded in parallel with a drive to limit competition (Pérez 1997; De Cecco 2009). Politicians, together with local bankers, orchestrated domestic bank consolidation and supported international expansion of their banks to create financial institutions that were impervious to foreign takeover by virtue of their size (Guillén/Tschoegl 2008; Deeg 2012). The situation in Spain, as the EU Single Market was being completed between 1986 and 1993, was typical: Market saturation and the competitive threats that European integration posed were the dual engines of internationalization. Spanish banks were still small relative to their European counterparts, and this played a key role in their strategic thinking. As one Santander executive put it, “We were a takeover target. We needed to grow. We went on a shopping spree” (Guillén/Tschoegl 2008: 74)[5].

The Eurozone’s first and second largest economies, Germany and France, also underwent domestic bank consolidation. In addition, they used their thin markets for corporate control to prevent foreign takeovers. Goyer and Valdivielso del Real (2014) show that France has used deviations from the one-share-one-vote principle to protect national ownership. Germany, meanwhile, was relying on ownership concentration and friendly acquisitions — even when the latter was extremely costly, as was the case with Commerzbank’s takeover of Dresdner Bank, just as the financial crisis was getting underway. While in France the state had openly intervened to protect the financial sector, in Germany the state’s role was more muted — at least until a series of national bank bail-outs in the context of the US financial crisis. And while Germany’s public sector banks have increasingly become subject to market rules through EU regulations, they are still enjoying a series of implicit subsidies, even after the financial crisis (De Grauwe/Ji 2013; Howarth/Quaglia 2014). Even the UK- not a Eurozone member- which has relatively high levels of foreign bank ownership because of its status as a financial center, has protected its small and medium sized enterprise (SME) lending segment with state directives (Busch 2009; Macartney 2013).

West European banking sector protectionism of the kind outlined above suggests the following paradox: politicians have frequently advocated financial integration and pan-European banking supervision, but have, even more assiduously, fought it in practice. This paradox is not limited to the EU’s biggest economies. A recent study that examines how banking sectors affect bank bail-outs across four European countries reveals the degree of internationalization in West European banking sectors. In no fewer than twelve EU member states (all in Western Europe), we find levels of banking sector internationalization[6] that are higher than in the United States - and in multiple cases, significantly so (Grossman/Woll 2014: 10). This is true even for relatively small European states, including Greece, Ireland, Austria and Portugal - countries that have historically maintained a critical mass of domestically-controlled banks. In spite of national political and regulatory participation in banking sector protectionism, the subsequent phase in European banking, in which sometimes very small financial institutions ultimately developed significant regional or even global reach, contributed to the shift in banks’ interests away from those of their home authorities (see also Spendzharova 2014a). While some highly internationalized banking sectors remained dependent on home governments and taxpayers for extraordinary levels of assistance in the 2008-09 crisis (which amounted to 229.4 percent of the GDP in Ireland’s case), there was no correlation between banking sector internationalization and the cost or extent of bank bail-outs (Grossman/Woll 2014: 10f). With broad internationalization in banking activity, banks became increasingly rooted in the fortunes of foreign markets.

5 In Europe, other banks that followed the strategy of becoming too big to takeover (with some proving more effective than others) included BBV, Argentaria and BCH, all of Spain; ABN AMRO of the Netherlands (Guillén/Tschoegl 2008: 74); Creditanstalt-Bank Austria, Erste and Raiffeisen of Austria, KBC of Belgium (Epstein 2013); and UniCredit and Intesa Sanpaolo of Italy (Deeg 2012).

6 ‘Internationalization’ is measured by the sum of external assets and liabilities as a percentage of GDP. Thus it is indicative not only of international activities but also of the size of the sector relative to the economy. See *Figure 3* in Grossman/Woll 2014:10.

Three examples of the diversification of banks' interests away from domestic markets and toward foreign ones are Erste, Raiffeisen (both of Austria) and UniCredit (of Italy), who all belong to the group of the biggest foreign investors in Central and East European banks. From the onset of postcommunist transition and the completion of the Single Market in the early 1990s, these banks all developed significant revenue streams abroad. Additional evidence of their new, foreign loyalties emerged in the 2008-09 phase of the financial crisis, when there were major fears about west European banks "cutting and running" from eastern markets (Epstein 2013). Such a development would have caused incalculable damage to Europe's emerging economies, but also threatened West European state finances and, by extension, the Euro. Fears of financial instability were compounded by West European domestic lending targets for assisted banks (*The Economist* 2009; IIF 2009) and West European regulatory demands that banks shore up capital and liquidity positions at home (Bakker/Gulde 2010).

Unusually, however, the major banks took exception to the urging of a 'home bias' in lending during the crisis.[7] In a letter from six major European banks to the European Commission and the then French Minister of Finance, Christine Lagarde, bankers raised the issue of the problem of financing for the real economies in Central and Eastern Europe, noting that countries such as Austria, Italy, France and Germany had taken measures to "sustain the flow of credit to their respective national economies". More critically, they went on to observe that the "more national dimension of these measures is going to enlarge disparities in credit availability between countries and could be ineffective in sustaining the European Economy as a whole".[8] For banks earning between a third and three quarters of their revenues from foreign markets, it is not surprising that they should resist a national logic in addressing an economic crisis.[9]

Returning to the theme of national authorities seeking to balance their own banks' risks against their returns, we find further evidence of how the internationalization of banks has created conflicts with home regulators. In 2011, the *Financial Times* reported that the three big Austrian banks' exposures (in terms of lending and holdings of debt) in the East amounted to more than Austria's GDP and the credit rating agencies were threatening with a downgrade for Austria (Frey/Buckley/Wagstyl: 2011). In response, the Austrian National Bank and the Austrian Financial Market Authority unilaterally imposed higher capital requirements on these banks, as well as limits on loan-to-deposit ratios: 110 percent on any new lending in Eastern Europe (Austrian National Bank (OeNB) and FMA: 2011). Because the new regulations were issued without consulting the banks, the East European hosts of Austrian banks, or even the European Commission, the result was plenty of fury - partly because the measures were discriminatory.[10] Not only would Austria's banks suffer a competitive disadvantage by being required to fulfill Basel III's capital requirement rules six years ahead of the general deadline, but there was no 110 percent loan-to-deposit-ratio limit for domestic lending in Austria. Ultimately, Austria's regulator backed down, and the measures became unenforceable

7 Normally, foreign banks do cut and run in economic crises (see Roubini/Setser 2004), in part because of national political pressure to boost home lending (Wade 2007). The financial crisis of 2008-09 in Europe was an exception; however, as western banks kept their exposure to East European markets (see Epstein 2013).

8 The Letter is dated 27 November 2008 and was signed by the CEOs of the following banks: Erste, Raiffeisen, UniCredit, KBC (of Belgium), Societe Generale (of France) and Intesa SanPaolo (also of Italy). Available at: http://www.ebrd.com/downloads/research/economics/events/Banks_letter.pdf, accessed 17 October 2013.

9 Epstein interview with a Raiffeisen banker, 19 April 2012, Vienna.

10 Epstein's interviews with an Erste banker, 19 April 2012; an OeNB official A; an OeNB official B, 18 April 2012, Vienna.

guidelines rather than firm rules. Increasing conflict between banks and their home supervisors should, however, not be confused with improved relations between foreign banks and their host supervisors. Bank-host tensions illustrate the extent to which multinational banking groups stand to gain from a single regulatory standard. With respect to the East European market, bankers complain that "capital mobility in Eastern Europe is dead". By this they mean that host countries had either increased or recently enforced liquidity and capital requirements during the crisis in ways that made it very hard for multinational banking groups to either move resources out of those markets, or to make independent decisions about dividend or bonus payments.[11] Another banker noted that it took him "nine years to persuade the Serbian authorities that I should be able to take my own profits out of their country".[12] Strains within Western Europe have also driven banks toward banking union. In the fall of 2011, German regulators ordered UniCredit to stop borrowing from its subsidiary in Germany: "The move angered Italy's central bankers and sent the relations between financial authorities into a nose dive" (Enrich/Galloni, 2011).

To be clear, not all European banks perceive benefits in moving toward a single rule book, harmonized regulation, centralized supervision, and diminished national discretion - the hallmarks of the European Banking Union. In particular, primarily domestically-oriented banks, of which there are many in countries as diverse as Germany, France, Italy and Spain, will not enjoy savings from lower costs of compliance that stem from harmonization and centralization. Moreover, domestically-oriented banks care less than their multinational counterparts about being able to move resources easily within their groups because they do not have cross-national considerations. Finally, domestically-oriented banks might even find themselves at a new competitive disadvantage under the European Banking Union because standardized capital and liquidity requirements are inconsistent with their nationally-distinct business models. But, as the foregoing paragraphs have shown, these exclusively domestically-oriented banks are now in the minority in terms of their assets, while multinational banking groups dominate lobbying organizations.

Multinational European banks have therefore launched a public relations campaign to reinforce the message that banking union should be achieved as quickly as possible to coincide with critical discussions among European leaders. In early September 2012, just before the European Commission published its proposal on establishing a single bank supervisor, the chief economist of UniCredit argued in the *Financial Times* that "a common bank supervisor is needed because banks, like most of the corporates they serve, have long ago moved from being national to international businesses, making the existing national supervisors model obsolete" (Nielsen 2012). And in mid-November 2012, just as the single supervisor discussions stalled in the Economic and Financial Affairs Council (ECOFIN), Emilio Botin, the chairman of Banco Santander, complained in the *Financial Times* (2012) that "there is no single banking market [and] Santander has met innumerable barriers to its attempts to expand in Europe. Most Latin American countries have been more open to our investment than many Eurozone member states […]. Banking union is an ambitious, complex and difficult process, both operationally and politically, but we cannot afford to postpone it" (Botin 2012).

11 Epstein's interview with an Erste banker, 19 April 2012, Vienna. See also Spendzharova (2012; 2014b) on the drive to keep national regulatory and supervisory control in countries with very high levels of foreign bank ownership.

12 Epstein's interview with a Raiffeisen banker, 19 April 2012, Vienna.

The European Banking Federation (EBF) has also become a firm and consistent supporter of all moves towards banking union proposed by the Commission, and advocates the further strengthening of those measures to achieve a high degree of cross-national policy harmonization. Indeed, as press reports, publications and statements by EBF Chief Executive Guido Ravoet reveal, the EBF has acted as a kind of cheerleader for the ECB and Commission regarding both the Single Supervisory Mechanism and the Single Resolution Mechanism (Ravoet 2014: 13f). The EBF has even played down the need for those banking union innovations that have not yet been achieved by the supranational authorities – such as the single European deposit guarantee, which many critics of the achievements to date have called the cornerstone of any 'real' banking union.[13]

This support has been invaluable in allowing the Commission to progress from allowing national initiatives to prevail in the first phase of the crisis (before 2010) to a second phase in which the clear intent is to transfer sovereignty to the supranational level. Nevertheless, we are not arguing that multinational banking groups have gotten everything they want from financial regulations after the crisis. The increase in regulation, especially in the form of more robust capital requirements, necessarily cuts into banks' profitability. Moreover, national discretions over regulatory standards remain (ESRB 2014: 21). Still, from the multinational banking groups' perspective, more harmonization and deeper single market integration is preferable to less, which is why they have consistently lobbied for that outcome (Corporate Europe Observatory 2014).

Banking nationalism in Western Europe, which was meant to allow states to retain control over financial power, has had the actual effect of first creating national banking champions that then became internationalized actors, increasingly market-oriented, with a diminished interest in privileging their home market over foreign ones. These frayed political ties between banks and states are consistent with recent research showing increasing market pressures on banks, which to diminishing extents can serve the traditional social function of "patient capital" identified in the comparative political economy and Varieties of Capitalism literature (on the first point, see Hardie et al. 2013; on the latter, see Zysman 1983; Hall/Soskice 2001). With bank internationalization, the interests of key actors in the debate over banking union have merged with those of the EU's supranational institutions. With at least one potential veto-player in banking union, the large transnational banks, effectively sidelined, the European Commission and the ECB have had more room to maneuver in favor of deeper integration.

3. Building the Banking Union: The Politics of Pooling Sovereignty and Centralizing Power

Centralized EU banking supervision, which has long been proposed by the European Commission, was clearly set out in a European summit at the end of June 2012, then detailed in the Commission's "Roadmap towards a Banking Union" in September 2012. It was formally embraced by European governments in their mid-October 2012 summit agreement (European Commission 2012). At that summit, European leaders set out to move ahead with the first steps towards a European Banking Union, specifically the creation

13 See, for example, 'Banking on a New Union: The Promises and Pitfalls of the Euro Zone's Next Big Idea', The Economist, December 14, 2013.

of a SSM for the Eurozone's approximately 6000 banks under the auspices of the European Central Bank. For individual banks, support from the €500 billion European Stability Mechanism (ESM), the permanent Euro bailout fund, would be conditional on their supervision being removed from national jurisdiction, a huge incursion on national sovereignty. This was a momentous set of commitments. For as Nicolas Véron has observed, surrendering banking sovereignty may be even harder for states than agreeing to monetary union. A functioning banking union in Europe would not only mean abandoning government influence over national banking systems, but also accepting important elements of fiscal union (through cross-border liabilities and transfers) and therefore a move towards political union as well (Véron 2012).

We argue that the European Commission and the ECB have exploited the costs of the European debt and currency crisis to consolidate their power.[14] The European Commission, since 2012, has enjoyed the support of peripheral countries (Ireland, Italy, Greece, Spain and Portugal), led by France, who favor, for reasons of national solvency, as rapid and complete a move towards an expansion of bank rescue funds at the European level as possible, and are willing to accept the transfer of sovereignty quid pro quo that implies. A northern camp, led by Germany, but also including the Danes, the Dutch and the Finns, has attempted to block both the transfer of sovereignty and the potential transfer of more funds from creditors to debtors that banking supervision and resolution threaten. The second camp enjoys the power resources conveyed by German leadership. But it has been weakened by the fact that both the Commission and the ECB, as well as the European Parliament and European banks have created a coalition in favor of centralization. The balance of power between the two camps has also favored the former over time because creditor country banks have been so heavily involved in financing the debt of the debtor countries, making their own banking systems vulnerable to the collapse of the latter's financial systems.

The second source of the Commission's increased influence derives from a combination of its constitutional powers of legislative preparation and proposition, its mastery of a complex field of policy, and its ability to engage in venue shopping in order to bypass or weaken potential vetoes. Banking, after all, is a highly technical area, and the Commission has been very ambitious in launching detailed initiatives and legislative proposals, coupled with an integrationist spillover rhetoric of "completing the unfinished project" of establishing the Single Market and the single currency (Vilpišauskas 2013). This rhetoric has been coupled with a TINA ("there is no alternative") discourse, reinforced by both the ECB and the economic and finance committees of the European Parliament.

The ECB has also accrued new powers during the crisis (Yiangou/O'Keeffe/Glöckler 2013). In addition to the rapid fulfillment of the mandate established in the mid-1990s, which has not resulted in a need for constitutional revisions behind this expansion of power, the mandate was complemented by a banking supervisory role at the end of 2012. The ECB managed to defuse the crisis in the financial markets after 2010 when the prospect of Greece, and eventually also Portugal, defaulting on their debts became very real. The ECB also stepped in to prevent a Europe-wide banking crisis in 2011 and 2012 by providing tranches of low interest rate loans to banks amounting to some €1 trillion through its Long-Term Refinancing Operations

14 Many observers argue either that intergovernmentalism in the crisis has weakened the Commission or that the Commission has been careful to act conservatively in the crisis (for example Hodson 2013). Others (notably Scharpf 2013) go further than we do and argue that the Commission has gone beyond its mandate and, strengthened by the new reverse-Qualified Majority Voting rule in the Council, has assumed almost dictatorial powers. There is less disagreement, however, regarding the strengthening of the ECB during the crisis (for example Yiangou/O'Keeffe/Glöckler 2013).

(LTROs). Finally, the ECB, together with the European Commission and the IMF, is also a member of the Troika that has managed and supervised multiple bail-outs in the Eurozone.

Despite the exigencies of the crisis, thwarting of the SSM by member-state opposition might have been possible. In fact, many observers and analysts believe this is precisely what happened, arguing that intergovernmentalism has dominated Europe's crisis response, with Germany posing the main obstacle to banking union. In reality, as we show in detail below, the Commission and the ECB have achieved pretty much everything they have sought in banking union policy innovation.

What we emphasize in the evidence below is that the Commission has been able to retain the Community method of policy making, despite Germany's consistent attempts to push banking union deliberations into intergovernmental channels. The Commission has retained control by exerting direct pressure on Germany's allies with arguments about the correct distribution of constitutional competences in the EU treaties and by using QMV in the Council of Ministers to pry the Dutch and the Finns away from their German colleagues (cf. Scharpf 2013).[15] In addition, the Commission has used venue-shopping (Baumgartner/Jones 1993) to bypass forums with high levels of technical expertise (in this case, ECOFIN). Instead it has sought to secure broad agreement in an intergovernmental forum, the European Council, so that it would subsequently be difficult for Finance Ministers to renege on commitments made by their Heads of State or Government. Such strategic venue-shopping has not only been used for the introduction of centralized bank supervision, but also for the ESM and the future resolution authority.[16]

In asserting this argument, we are clearly contradicting a more pervasive view that the emergence of the European Council as a major policy deliberating and bargaining forum in the crisis reveals the triumph of an intergovernmental logic in the workings of the European Union – to the detriment of the standard Community method of policy making. We support our claim by looking at several key episodes in the construction of the banking union: awarding EU banking supervisory powers to the ECB; allowing the ESM, the successor to the EFSF, to recapitalize banks; and the creation of a banking resolution system, comprising a Single Resolution Board and Fund.

3.1 The Single Supervisory Mechanism

Beginning with the Single Supervisory Mechanism, the German government, which originally agreed to the creation of an SSM in a summit of EU leaders in October 2012, but then fought against its implementation, has gradually given way to a more expansive notion of ECB banking supervision than it had originally deemed acceptable. The German Government and its allies were opposed to the ECB supervising all banks and not just cross-border ones (especially German local and regional banks). The Commission, France and the smaller member states wanted all banks supervised by the ECB. The French were opposed to the possibility of unequal treatment of different member states given that its own banking system is dominated by five very large banks that would all fall under direct ECB supervision (Howarth/Quaglia 2013).

15 Epstein-Rhodes interview with a European Commission official, September 2013, Denver, Colorado

16 Epstein-Rhodes interview with a European Commission official, September 2013, Denver, Colorado

In early December 2012, as discussions got underway in ECOFIN, German Finance Minister Wolfgang Schäuble announced that his government would oppose full supervision, stating that "[i]t would be very difficult to get approval by the German parliament if [the deal] would leave the supervision for all the German banks to European banking supervision. Nobody believes that it would work" (EUobserver 5 December 2012). On 6 December 2012 ECB President Mario Draghi fought back, arguing in line with the Commission, that it was crucial for the new supervisor to supervise all 6000 banks in the Eurozone in order to boost market confidence. He also tried to take a conciliatory stance by stating that the ECB's position was not all that different from Germany's, which holds that as the systemic significance of a bank increases, there will be more scope for supervision solely at the central level. The Germans responded by saying that, although they wanted the ECB to have real auditing powers, national supervisors should be in charge of smaller banks - in line with lobbying from the German *Landesbanken* (regional banks) and *Sparkassen* (savings banks) that regulation should follow a subsidiarity principle, and remain as close to the object of regulation as possible.

In a compromise drafted by the Cypriot EU presidency, banks with assets worth more than €30 billion and engaged in cross-border activities should be under ECB supervision, while the rest remained under national supervision. "Ultimate responsibility" should lie with the ECB (EUobserver 10 December 2012). However, Germany (and its allies) argued that the threshold for supervision should be set closer to $50 billon. And they also exerted pressure in order to postpone the ECB's supervisory role until July 2014. Meanwhile, there were also divisions within the German camp that would endure through other banking union controversies. While German Central Bank President Jens Weidmann consistently argued for a treaty change to give the ECB new powers, the German Government held that the treaty base was acceptable (EUobserver 13 December 2012). Even after the final deal was struck in mid-December 2012, Weidman stated that he was "not convinced that the ECB council is the optimal authority to decide when a bank has to be closed down or not" (EUobserver 18 December 2012).

The final agreement achieved on 13 December 2012, departed significantly from Germany's original position and that of its allies. It was decided that the ECB would be responsible for the SSM and have direct oversight of Eurozone banks – to be carried out in close cooperation with national supervisory authorities. Direct supervision was to concern the 200 largest Eurozone banks (including groups), but the ECB could step in and, if necessary, supervise any of the Eurozone's 6000 banks. The starting date for ECB supervision was set for January 2014, later than indicated by EU leaders in October, but sooner than had been requested by the German government. And it was the €30 billion threshold for supervision, rather than the €50 billion the Germans had called for, that was entered into the document. To placate the German group, and to resolve disputes between the ECB and national supervisors, a mediation panel was created. To ease German concern about the independence of the ECB, a special supervisory board was to be set up to separate its monetary policy role from bank supervision. As for Germany's aim to protect its *Landesbanken* from ECB supervision, all German *Landesbanken* (along with many other Eurozone cooperatives and national or local government-controlled banks, including savings banks) were placed on the list for the ECB's 'Comprehensive Assessment' (including an Asset Quality Review, or AQR, stress tests and a 'supervisory risk assessment') announced in October 2013 (Véron 2013a, 2013b). The German Bundesbank remained unhappy about these developments, and as late as July 2013, its monthly report continued to reiterate its skepticism of ECB's combining supervisory powers and monetary policy tasks (EUobserver 23 July 2013)

- to little avail. A major shift in sovereignty had occurred, with enormous consequences for the national control of banking systems.

3.2 The ESM and the Recapitalization of Banks

The ESM replaced the EFSF in September 2012 and was to have full lending capacity of €500 billion by 2014. Member states of the ESM could apply if their financial sector was in difficulty, but bail-outs were to be linked to conditionalities. The Commission proposed that the ESM should be used to support failing banks directly. The temporary EFSF and the permanent ESM in operation from late September 2012 fell short of French ambitions (Howarth/Quaglia 2013: 104, 111) and were given more restricted mandates: they were allowed to purchase sovereign debt only on secondary markets.

Merkel agreed reluctantly to set up the permanent ESM, in return for a demand that countries sign up for the so-called fiscal compact – a short treaty enshrining budget discipline into national law – and bail outs were supposed to be conditional on a country first ratifying the compact. Following the establishment of the ESM in March 2012, there were numerous challenges to it, for example from the Dutch Court of Auditors and multiple complaints from Germany, destined for the German Constitutional Court in Karlsruhe. The Karlsruhe court had already ruled on the EFSF, however, arguing that it did not contravene the German Constitution (7 September 2011). Therefore, it was unlikely to come to a different judgment on the ESM.

In late November 2012, European Council President Herman Van Rompuy published a paper titled "Towards a Genuine Economic and Monetary Union", which largely aligned with French policy preferences. It called for the quick adoption of a legal framework by early 2013 to allow the ESM to begin direct bank recapitalizations by spring of the same year. However, somewhat earlier, in late September 2012, the German, Dutch and Finnish governments had made it quite clear that they opposed any agreement enabling the ESM to recapitalize banks without prior agreement on an adequate regulatory and supervisory framework and reinforced fiscal policy rules. Banks in difficulty should remain the primary responsibility of their governments. The ESM was only to be used to help banks facing difficulty in the future - arising under supervision of the ECB in a new banking union (Howarth/Quaglia 2013: 112).

In fact, despite German opposition to using the ESM for bank recapitalization, in early June 2012 the Eurozone Finance Ministers had already agreed to release up to €100 billion for the recapitalization of Spanish banks from the bail-out funds without an accompanying austerity program. And in early December even Germany had announced its willingness to accept an immediate and exceptional recapitalization of four nationalized Spanish banks – transferring €39.5 billion from the ESM to Spain's "fund for orderly bank restructuring (Howarth/Quaglia 2013: 112). This appeared to be a case of the circumstances overwhelming German principles. Nevertheless, Germany and its allies continued to fight a rearguard battle over the institutionalization of what it clearly saw as short-term and ad hoc crisis measures. The problem was that, having agreed to a supranational solution in the case of Spain, the coordinating capacity of the supranational institutions had been affirmed, and there was no alternative for Germany to appeal to.

German Finance Minister Wolfgang Schäuble, who had led the resistance to the ESM's direct recapitalization of banks, now called this move an "important step on the way to the banking union by agreeing on the main points for a future regime for direct bank recapitalization" (EUobserver 21 June 2013). In May 2013, in an op-ed in the *Financial Times*, Schäuble went so far as to note that "effective fiscal backstops [could] include the European Stability Mechanism as a last resort" (Schäuble 2013). However, in mid-October 2013, Schäuble came under pressure from the German Social Democrats, during coalition negotiation talks with the Christian Democrats, to resist ESM involvement in bank recapitalization, arguing that it would require a change in German law - a tactic to indefinitely delay adoption (Buergin/Parkin 2013). Nevertheless, the European Council of 24-25 October 2013 called on the Eurogroup "to finalise guidelines for European Stability Mechanism direct recapitalisation so that the European Stability Mechanism can have the possibility to recapitalise banks directly, following the establishment of the Single Supervisory Mechanism" (European Council 2013: 16). And on 5 May 2014, Eurozone Finance Ministers agreed that the ESM should be able to invest directly in banks by 2015 in the event that raising money from private investors or the government failed to strengthen a bank identified in the ECB's Asset Quality Review (Reuters 2014).

3.3 Bank Recovery and Resolution

Closely linked to the bank recapitalization issue was the wider question of bank recovery and resolution. In the early months of 2013, the German Government opposed the creation of a single authority to shut down banks with access to common funds, deriding the project as "premature and unwise". A diplomatic battle followed, with position papers - some secret, some public - issuing forth from Paris and Berlin, illustrating separate visions. The ECB, highly frustrated at Berlin's position, weighed in in April 2013 with all six ECB executive board members publicly backing the creation of a single resolution authority, while ECB president Mario Draghi stated that reform must come "quickly". French Central Bank governor Benoit Coeuré likened the lack of a common resolution authority to wading across a river and stopping half way (Baker/Ehrlich 2013: 2). At a meeting of the EU finance ministers in Luxembourg on 21 June 2013, there was an attempt to strike a deal on a regime to wind down banks and break the 'doom loop' between banks and sovereigns. The Commission's Bank Recovery and Resolution Directive (BRRD), tabled in June 2012 and seen as the complement to a single resolution mechanism (SRM), presented a hierarchy of shareholders and creditors who would be 'bailed in' to bear losses if a bank got in serious trouble, leaving savers as last in line to lose money (EUobserver 21 June 2013). The main stumbling block at the EU finance ministers' meeting was over how much flexibility national governments should be granted in making decisions on winding down banks (EUobserver 24 June 2013).

On 27 June 2012 the Finance Ministers forged a compromise: under the new regime banks' creditors and shareholders would be the first to take losses. Only if that measure was insufficient, private savers with deposits of more than €100,000 would also have to contribute to the costs. The principle of 'bail-in' was thereby firmly established and the principle - if not the final decision - that the ESM could recapitalize banks was confirmed (EUobserver 27 June 2013). Shortly thereafter on 10 July 2013, the Commission proposed the creation of a common Eurozone authority backed by a fund to decide on the fate of ailing banks. Under this proposal, an EU agency with 300 staff would supervise national regulators on ailing banks and prepare plans to wind them down. The European Commission would then make the final decision on whether and when to put a bank into resolution – making the European Commission itself the single resolution authority. This mechanism would cover the roughly 6000 banks falling under the SSM. The single bank resolution fund would pool funds collected at the national level from levies on banks. Its total projected size of around €55 billion would be equivalent to 1 percent of deposits held by banks – to be built up gradually over ten years.

In response, the German government made it clear that the power to take a bank into resolution should still lie with national authorities, and stated its fear that the common resolution fund would likely become just another de facto bail out mechanism. The German government spokesman, Steffen Seibert, argued that “the proposal gives the European Commission a competence it cannot have based on the current treaties” (Financial Times 2013). German Finance Minister, Wolfgang Schäuble, had already suggested in May 2013 that instead of a single resolution authority it would be more appropriate to have a “network of national resolution authorities” until EU treaty rules were changed (Schäuble 2013). Michel Barnier, European Commissioner for Internal Market and Services, strongly retorted that “we have carefully analyzed the legal certainty in this text”. Barnier said that the proposal was based on Article 114 of the EU Treaty regarding the harmonization of national laws for the aim of creating a single market.

However, by the last week of October 2013, there were signs that the German position was shifting. On October 23, on the eve of the EU summit in Brussels on 24-25 October, Mario Draghi stated impatiently that EU political leaders had made “an explicit commitment to have in place proper, adequate national backstops by the time the exercise [the ECB’s stress tests and balance sheet reviews] is being carried out. We have a commitment at the highest level.” (Financial Times 2013). The same day, a senior German official stated that Chancellor Angela Merkel was set to have a “constructive stance” on the matter and to seek a deal among the member states by the year’s end (EUobserver 23 October 2013). A treaty change was not mentioned. In fact, German officials revealed that Angela Merkel’s Chancellery had already, before the German elections in late September, come around to the idea that the Single Resolution Mechanism (SRM) could be put in place by a regulation on the basis of Article 114 of the Treaty on the Functioning of the European Union (TFEU) that allows for the approximation of national provisions relating to establishment of the Single Market - just as the Commission had argued.

The conclusions of the European Council of 24-25 October 2013 stated clearly that the SRM was to be adopted with utmost urgency to complement the ECB’s Asset Quality Review (European Council 2013). The first clear result came from talks in Strasbourg on 11 December 2013, in which negotiators for the European Parliament and EU member states brokered a deal on the Bank Recovery and Resolution Directive (BRRD) which will come fully into force in 2016. The new ‘bail-in’ regime will force shareholders, bondholders and some depositors to contribute to the costs of bank failure: insured deposits under €100,000 are exempt and uninsured deposits of individuals and small companies are given preferential status in the bail-in pecking order. Member states agreed to establish resolution funds or introduce corresponding levies, which over the next decade should raise the equivalent of 1 percent of covered deposits, or roughly €70 billion across the EU. Michel Barnier stated that “With these new rules in place, massive public bailouts of banks and their consequences for taxpayers will finally be a practice of the past.” (Barker 2013).

At the ECOFIN meeting on 18 December, a further compromise was forged on the Single Resolution Mechanism itself (European Commission 2013). There is a great deal of intergovernmentalism in the final compromise, and for many observers this was a sign that Germany had come out on top. And yet, there is a very strong dose of supranationalism as well, and the path put in place leads to further future European centralization of banking resolution rather than an ongoing awkward intergovernmental status quo. Thus, a regulation (based on Art. 114) has established both the Single Resolution Board, that will apply the Single Rulebook on bank resolution to banks in the participating member states, and the Single Resolution Fund. But the functioning of the Fund (the transfer of contributions from member states and the mutualization of national financial resources) is governed by an intergovernmental agreement in order to avoid legal challenges at the request of the Council (European Commission 2014).

The system will function in the following way: the Single Resolution Board, involving the Commission, the Council, the ECB and the national resolution authorities, owns the Single Resolution Fund. Under the established procedure, the ECB will notify the Board, as well as the relevant national resolution authorities and ministries, when a bank is failing. The Board, comprised of an Executive Director, four other permanent members, with the Commission and the ECB as permanent observers, will assess whether there is a systemic threat and any private sector solution. If not, it will adopt a resolution scheme including the relevant resolution tools and the use of the Fund. The resolution scheme is then to be implemented by the national resolution authorities (European Commission 2013). Although a complex solution, in the event of a bank failure, decision making will likely be restricted to a small group of actors who know the details of the case and who will have to act quickly while markets are closed (Gros 2014).

The strongest degree of intergovernmentalism is found in the Single Resolution Fund itself, as well as the strongest German imprint. Germany is the only EU member state with its own resolution fund, and German banks have consistently lobbied their government to retain that fund. At a meeting of EU finance ministers, member states committed themselves to an inter-governmental agreement specifying the channeling of funds (€55 billion, raised by levies on banks at the national level) to the Single Resolution Fund. The progressive mutualisation of funds will take place over ten years. Thus, the SRF is not really “single” either: it is enshrined in an intergovernmental treaty and will not be a “single fund”, as per current plans, until 2025, when national funds are fully mutualized.

Nevertheless, some observes (for example Gros 2014) argue that once put in place, this intergovernmental arrangement, like the Schengen agreement, will inevitably be integrated into EU law, placing it under the control of the Commission and Parliament. Moreover, even German Finance Minister Schäuble conceded by February 2014 that it might be preferable to accelerate mutualization.[17] In the end, the hand of Schäuble and other finance ministers was forced by the European Parliament in mid-April 2014 when, in return for its support for the resolution authority and fund, governments conceded a much speedier mutualization of the fund: forty percent of the fund was to be mutualized in the first year, twenty percent in the second year,

17 On 17 February in the *Financial Times*, Schäuble stated that “[i]f 10 years is too long to build the fund, let’s speed up – but not only the speed of mutualisation but the speed of paying in.” And while Schäuble himself remained resistant to proposals that would allow the fund to borrow money, his erstwhile faithful ally Jeroen Dijsselbleom, the Dutch finance minister, said he was open to giving the fund the power to borrow, backed by national guarantees.

and the rest equally over a further six years (EUobserver 16 April 2014). But regardless of timing, we argue that the critical decision is that of mutualizing SRF funding across the member states (a significant form of fiscal transfers) rather than its form of management or speed of introduction.

4. Alternative Explanations

There are at least two alternative explanations to our own. The first competing interpretation would be that the European response to the crisis, including to bank governance, has been largely national in character, a rationale that has been supported by the European Commission (Donnelly 2014). In a series of articles, Wolfgang Münchau has argued that banking union is necessary “to prevent doubts about the solvency of national governments from undermining confidence in their banks”. To the extent that, when there is insufficient European funding for a banking union, including, for example, for the Single Resolution Mechanism, confidence will not be restored. Thus, Münchau concludes, “A bad banking union is worse than none” (Münchau 2014: 7). While we agree with Donnelly on the point that national prerogatives did prevail to a great extent in the first phase of the crisis, we contend that by 2012, supranationalism gained momentum. A fuller appreciation of the linked vulnerabilities between states and banks emerged with the Spanish crisis and heightened borrowing costs for Italy. It was also in 2012 that French banks, as well as the French government, reversed their positions on the banking union to embrace it. The shift to supranationalism is reflected in the changed locus of authority for bank supervision. As the Asset Quality Review (AQR) was getting under way in early 2014, Danièle Nouy, head of the SSM, made clear that “some banks have no future” (Jones/Ross/Fleming, 2014: 1). She was also intent on requiring banks to hold capital against their own sovereigns’ debt to sever the link between banks and states, and, likewise, determined to prevent national regulators from protecting their banking champions and from putting up de facto barriers to capital flows between member states. Moreover, in contrast to the stress tests of the European Banking Authority, which were revealed to be totally lacking in credibility given the failure of Franco-Belgian bank Dexia only three months after it had passed the tests, there is much stronger incentive to comply with the ECB’s new powers because so much more is at stake. “We know we have a single opportunity to establish our credibility and reputation,” remarked Nouy (Fleming/Ross/Jones 2014: 3). But she and the SSM have also been helped by the wide recognition that any financial instability resulting from the ECB being discredited during the AQR and subsequent supervision would be broadly punishing.

The second alternative argument to our own is that Germany took a position more extreme than its genuine intent, in order to eventually reach a moderate position in the negotiations on banking union. We would point out, however, that Germany consistently resisted solutions to the crisis that pooled liabilities across the Eurozone. Nevertheless, Germany and its allies failed to prevent agreement on the critical components of the banking union, including a certain degree of mutualization. We argue that the banking union outcome was a consequence of the array of interests lined up against Germany on mutualization. It is one thing to resist appeals for greater solidarity from the weak peripheral member states (a position that Germany has shared with the Commission and the ECB), and quite another to fight and win against a much larger coalition comprising the Commission, the ECB and the European Parliament, as well as the largest European banks and their European-level associations. Our second response is to point to the origins of the

German position in domestic lobbying, the genuine expression of the interests of German banks, particularly in the public sector. They have lobbied consistently to retain national supervision and resolution funding, but have lost on both: even if German savings banks are excluded from direct supervision, all German banks fall under ECB monitoring. And the compromise over banking resolution and rescue provides for a pooling of resolution decision making and a mutualization of funds. These changes run directly counter to the revealed preferences of the German banking sector, and may also disrupt traditional channels of funding to critical parts of the German economy. We therefore conclude that German authorities have not been dissimulating in trying to preserve national sovereignty in the face of momentum towards a European Banking Union.

5. Conclusion

We have argued that there have been important structural shifts in the European banking system and major policy changes in the Eurozone that have weakened the hold of nations over their banks and raised the costs of banking protectionism. The financial crisis has highlighted the adverse consequences of the so-called 'doom loop' between banks and sovereigns, creating a threat to the wider European economy as a whole. The crisis has further fragmented the European banking market, thereby reducing the liquidity needed to fuel European growth and disrupting monetary policy transmission. Against this background, a coalition of supranational institutions, member state governments and private actors in the banking sector mobilized behind ever closer banking union against the opposition of Germany and its allies, principally the Netherlands and Finland. But the perceived need to solve collective action problems shifted the balance of opinion and power in favor of EU-level centralization of banking authority.

The German position, weakened by competing views of the Merkel cabinet on one side and the Finance Ministry and Bundesbank on the other, has also shifted on the key issues at stake. Even in the area of Germany's greatest success – that of securing a largely intergovernmental solution to bank resolution and rescue – the German position runs into problems. In particular, the weaknesses of that construction and its potential for creating collective action problems, suggest that the Commission and ECB will ultimately seek a transition to a more supranational solution. Indeed, the common pattern running through all three examples of conflict and compromise has been German obduracy at the outset, followed by a gradual softening of its position under the influence of Commission and ECB insistence. The essence of this process was well captured by a senior Commission official who, reflecting on the painful search for agreement on a single supervisory mechanism, remarked in the midst of the battle over bank resolution, that "[w]e've heard this record before: Angela Merkel signs up to an idea and her finance ministry and lawyers spend a year telling us why it can't be done." (Barker/Ehrlich 2013).

Ultimately, though, Germany has by and large accepted the idea of a banking union put in place by the European authorities, securing, of course, some concessions along the way. Many analysts place greater emphasis on the concessions made *to* the Germans than on the concessions made *by* the Germans and their allies. There is a tendency to emphasize the delays and slowness with which the banking union has been implemented. We note, however, how momentous the steps taken in just two years have been. Especially, if we remember that, prior to the establishment of the common currency in 1999, the parallel surrender of sovereignty demanded by EMU took more than a decade, or longer if one considers its antecedents in the EMS and the European currency "snake"[18], which date back to the dissolution of the Bretton Woods international monetary regime in the early 1970s.

18 The EU's first attempt at monetary cooperation in the 1970s by pegging the EEC currencies to one another via a single currency band.

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